THE BRANDES INSTITUTE

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Death, Taxes and Short-Term Underperformance: International Funds

"In this world nothing can be said to be certain, except death and taxes."[1] —Benjamin Franklin

INTERNATIONAL-MARKET FUND SAMPLE

- 145 mutual funds
- From the Morningstar database as of 6/30/2014
- Actively managed international funds
- 15 years of performance data available

The Brandes Institute has added a third inevitability to Ben Franklin's famous quip about life's certainties: short-term underperformance among active managers. Over the years, Institute research has shown active managers, even the best-performing ones, suffered periods of weak returns relative to benchmarks and their peers. But underperformance, up to three years, had relatively little impact on the best-performing funds' ability to deliver success over 15 years.

It may prove short-sighted to fire good managers when they inevitably underperform. Instead, consider other vital factors when evaluating managers—such as investment philosophy, process, organizational culture and alignment with client interests—to help discern weak short-term returns from other, more serious problems.

The original *Death, Taxes and Short-Term Underperformance* studies examined short- and long-term returns for U.S. and fixed-income mutual funds. We extended the study to international funds and found the same patterns of short-term underperformance for the best-performing funds.

Investigating Short-Term Underperformance in International Markets

- Identify the top long-term performers
- Reveal their short-term challenges along the way

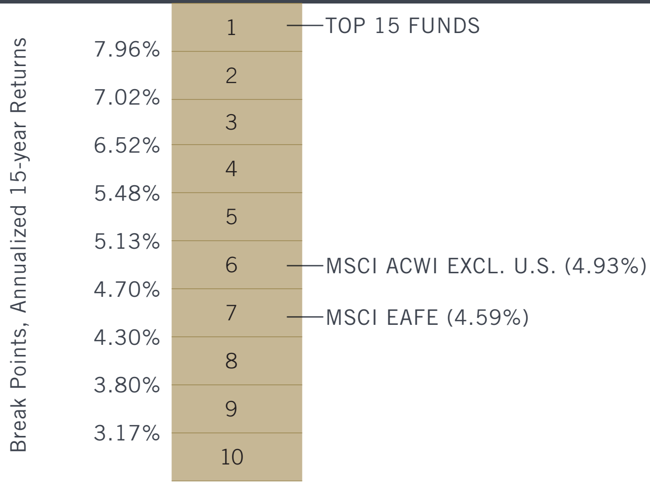
To investigate actively managed international funds, we applied the same methodology from prior studies. Using the Morningstar database, we focused on funds that followed value, growth, or blend mandates and had at least 15 years of performance data as of June 30, 2014. Funds with multiple share classes, index funds and enhanced index funds were excluded, yielding a sample size of 145.

The sample was divided into deciles based on the funds' performance for the entire 15-year period. For example, decile 1 consisted of the 15 funds with the highest 15-year returns, while the 14 funds with the next-highest returns formed decile 2, and so on.[2] All mutual fund performance figures assume the reinvestment of interest and capital gains, include the impact of the funds' fees and expenses, and do not include the impact of taxes.

Exhibit 1, on page 2, shows the top 15 mutual funds in the sample posted an annualized gain of at least 7.96% over the 15-year period. All of these "decile 1" funds outperformed the MSCI international equity index (MSCI EAFE) which returned an annualized 4.59% over the 15 years.

[1] Source: notable-quotes.com, from a letter to Jean Baptiste LeRoy, 11/13/1789.
[2] Per statistical convention, deciles 1, 3, 5, 8 & 10 contained 15 funds while the deciles 2, 4, 6, 7, & 9 contained 14 funds.

Exhibit 1: International Equity Funds Ranked by 15-Yr. Annualized Performance, 1999–2014



Sources: Morningstar, Brandes Institute; as of 6/30/2014. Past performance is not a guarantee of future results. One cannot invest directly in an index.

Short-Term Snapshots Reveal Dramatic Underperformance vs. Benchmark

While the top 15 funds outdistanced the benchmark for the 15-year period as a whole, all of them underperformed the Index significantly during shorter periods. For instance, in their worst 1-year rolling periods, the top 15 funds underperformed the Index by margins ranging from -4.64% to -33.02%, as illustrated in Exhibit 2. On average, these funds trailed the Index by -13.17% in their worst 1-year rolling period. Underperformance versus the Index was also noteworthy in each fund's worst 3-year rolling period.

Exhibit 2: Top 15 Funds: Relative Performance vs. MSCI EAFE Index
1999–2014 (Annualized)

	Worst 1-Year Rolling Period	Worst 3-Year Rolling Period
Range	-4.64% to -33.02%	-1.08% to -18.61%
Average	-13.17%	-5.45%

Source: Morningstar, Brandes Institute; as of 6/30/2014. Past performance is not a guarantee of future results. One cannot invest directly in an index.

Exhibit 2 reveals the magnitude of short-term underperformance that even top international funds experienced. At the time, such poor relative returns may have been deemed "unrecoverable" by some frustrated investors and may have prompted them to close their accounts. However, abandoning one of these top-performing funds during a bout of weak returns probably would have been a mistake. Our research shows significant short-term underperformance for international equity funds has not been unusual, even for those funds that outperformed over the long term. In fact, poor short-term relative returns were common among each of the funds exhibiting the best long-term results. These findings underscore the importance of looking past short-term performance and focusing on longer-term potential.

Underperformance vs. Peers

In addition to investigating performance relative to the Index, we studied these funds' performance relative to peers over the decade, ranking them over rolling quarterly, 1-year and 3-year periods. Similar to the pattern exhibited for *benchmark*-relative returns, the top-performing funds each found themselves in lower deciles when compared with their peers over shorter periods.

In fact, in terms of quarterly performance, all 15 of the top funds (100%) made at least one below-median appearance (at or below decile 6) during the decade—and all of them showed up in the worst decile (decile 10) for at least one quarter.

When it came to 1-year and 3-year periods, the top 15 funds also experienced underperformance relative to their peers, as shown in Exhibit 3. For example, 100% of the funds made at least one appearance in deciles 6, 7, or 8 for 1-year returns. Looking at 3-year returns, all of the top 15 funds were below median at least once and eight of them of them fell to decile 10.

Exhibit 3: Over 15 Years, All of the 15 Top-Performing Funds Fell Behind at Some Point

	Percentage of Top 15 Funds with at Least One Appearance at or Below				
Decile	6	7	8	9	10
	Underperforming Funds			Worst-Performing Funds →	
Quarterly Performance	100%	100%	100%	100%	100%
Annualized 1-Year Performance	100%	100%	100%	93%	73%
Annualized 3-Year Performance	100%	93%	87%	67%	53%

Source: Morningstar, Brandes Institute; as of 6/30/2014. Past performance is not a guarantee of future results.

Again, these findings suggest that short-term underperformance relative to peers is to be expected, even for funds that perform well over the long term.

Short-Term Underperformance as Normal as Death and Taxes

Whether relative to a benchmark or peers, short-term performance can be frustrating. However, we believe that it may not necessarily be a cause for alarm, and may even be an inherent byproduct of the investment process that is behind a successful longer-term record.

As a result, we think that underperformance in shorter periods—such as one quarter, one year, and perhaps even a few years—can be a normal part of the investment experience, even for funds that perform well over longer periods. In our opinion, investors who keep this in mind when evaluating short-term returns may be better positioned for long-term success.

International and emerging markets investing is subject to certain risks such as currency fluctuation and social and political changes, differences in financial reporting standards and less stringent regulation of securities markets which may result in greater share price volatility; such risks are increased when investing in emerging markets. Additional risks associated with emerging markets investing include smaller-sized markets, liquidity risks, and less established legal, political, social, and business systems to support securities markets. Some emerging markets countries may have fixed or managed currencies that are not free-floating against the U.S. dollar. Certain of these currencies have experienced, and may experience in the future, substantial fluctuations or a steady devaluation relative to the U.S. dollar.

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Index Guide:

The MSCI EAFE (Europe, Australasia, Far East) Index with net dividends measures the equity market performance of developed markets in Europe, Australasia, and the Far East.

The MSCI All Country World Index with net dividends measures the equity market performance of developed and emerging markets.

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